

# IRC §42, Low-Income Housing Credit - Part V Qualified Basis

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## Chapter 13 Qualified Basis

### Introduction

Qualified basis is the portion of a low-income building's eligible basis associated with the low-income units.

Eligible Basis x Applicable Fraction= Qualified Basis

While qualified basis is a function of both eligible basis and the applicable fraction, there are specific IRC §42 rules and limitations applied to qualified basis as a whole.

### Topics

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## **Law**

### **Qualified Basis Defined**

Under IRC §42(c) (1), the qualified basis of any qualified low-income building for any taxable year is an amount equal to:

- the applicable fraction (determined as of the close of such taxable year) of
- The eligible basis of such building determined under IRC §42(d) (5).

A qualified low-income building's qualified basis is determined for each taxable year in the building's 15-year compliance period. To qualify as a low-income building, the building must be part of a qualified low-income project beginning on the first day in the compliance period on which such building is part of such a project, and ending on the last day of the compliance period for that building. See IRC §42(c) (2).

### **Increases to Qualified Basis**

Qualified basis is initially determined at the end of the first year of the credit period and, since the eligible basis is fixed at the same time, qualified basis is (generally) a function of the applicable fraction. The qualified basis may increase after the initial determination, but only if the number of qualified low-income units increases after the end of the first year of the credit period; i.e., the applicable fraction increases.

The credit associated with an increase in qualified basis after the end of the first year of a building's credit period is computed differently than the credit determined at the close of the first year of the building credit period. Under IRC §42(f) (3) (A), the applicable percentage under IRC §42(b) is equal to two-thirds of the applicable percentage that would otherwise apply to the building. As a result, the credit associated with an increase in qualified basis is commonly referred to as the "2/3 credit."

#### **Example 1: Increase in Qualified Basis**

A taxpayer owns a qualified low-income building with 100 units for which the eligible basis is \$10,000,000. The applicable percentage is .0835 and the applicable fraction at the end of the first year of the credit period was .8500; i.e., 85 of the 100 units are qualified low-income units.

The qualified basis for the first year of the credit period is:

$$\$10,000,000 \times .8500 = \$8,500,000$$

The credit for the first year of the credit period is computed as the qualified basis times the applicable percentage:

$$\$8,500,000 \times .0835 = \$709,750$$

The applicable fraction for the second year of the credit period was .950. The qualified basis is  $\$10,000,000 \times .9500 = \$9,500,000$  and the increase in qualified basis is

$$\$9,500,000 - \$8,500,000 = \$1,000,000.$$

The credit for the initial qualified basis is the same as computed for the first year of the credit Period, \$709,750.

The 2/3 credit associated with the \$1,000,000 increase in qualified basis is computed as:

$$\$1,000,000 \times (.0835) (2/3) = \$55,611$$

In total, the taxpayer may claim credit equal to \$765,361, computed as  $\$709,750 + \$55,611$ .

### **Rules Relating to Increases in Qualified Basis**

Increases in qualified basis are subject to the following rules:

Under IRC §42(f) (3) (B), when computing the applicable fraction for the increase in qualified basis for the first year of the increase, the special rule for the first year of the credit period in IRC §42(f) (2) is applied; i.e., the sum of the applicable fractions determined at the end of each full month of such year divided by 12. See Chapter 12.

The computation of the applicable fraction for the increase in qualified basis was not shown in the example above. Suppose the taxpayer uses a calendar tax year and that 10 additional units were rented to qualifying households in January of the second year of the credit period, the first month of the taxable year and remained low-income units the entire year. The applicable fraction would be .10, computed as  $10 \div 100$ , each month for 12 months, the sum of which is divided by 12 month.

$$(10 \text{ units} \div 100 \text{ units}) \times (12 \text{ months}) \div (12 \text{ months}) = .100$$

The increase in qualified basis can only result from an increase in the applicable fraction; i.e., low-income units are first occupied by qualifying households after the end of the first year of the credit period.

The sum of the credit associated with the initial qualified basis and the 2/3 credit cannot exceed the maximum allowable credit allocated to the building by the state housing agency.

The 2/3 credit is claimed for each remaining year in the 15-year compliance period after the end of the first year of the credit period that the unit qualifies.

## **Decreases in Qualified Basis**

### **Nonrecourse Financed**

Under the IRC §42(k) (1) credit at-risk rules, an IRC §42 building's qualified basis is reduced by the amount of any nonqualified nonrecourse financing. Nonqualified nonrecourse financing may be identified as part of the analysis of a taxpayer's financial resources. See Chapter 10 for complete discussion.

### **Maximum Qualified Basis**

IRC §42(m)(2) requires state housing agencies to limit the amount of credit allocated to a building so that it does not exceed the amount necessary to ensure the building's financial feasibility and viability as a qualified low-income housing project throughout the credit period.

This limit on the credit amount can be accomplished by limiting the qualified basis used to compute the credit. Under IRC §42(h) (7) (D), the state agency making the credit allocation specifies the maximum qualified basis associated with the low-income building. The maximum qualified basis specified can be less than, but never more than, the actual qualified basis. The building's maximum qualified basis is documented on Form 8609, line 3a.

When the actual qualified basis exceeds the maximum qualified basis, the difference is commonly referred to as "excess basis." See Chapter 15 for additional discussion.

## **Supportive Services for the Homeless**

### **Limitation on Costs Included in Qualified Basis**

Under IRC §42(c) (1) (E), a low-income building's qualified basis includes the portion of the building used to provide supportive services for homeless individuals. If the building qualifies as transitional housing under IRC §42(i) (3) (B) (iii), then the qualified basis for any taxable year is increased by the lesser of:

- so much of the building's eligible basis as is used throughout the year to provide supportive services designed to assist tenants in locating and retaining permanent housing, or
- 20% of the qualified basis of such building (determined without regard to the facility used to provide supportive services).

### **Imputed Zero Qualified Basis**

A building's qualified basis can be deemed to be zero, as described in the following examples. Other fact patterns may result in the same treatment.

- The entire building is noncompliant with IRC §42 requirements. For example, the building is not considered suitable for occupancy because of building-level noncompliance with the Uniform Physical Condition Standards. See CCA 201042025.
- The project, of which the building is a part, did not satisfy the minimum set-aside requirement under IRC §42(g) (1). See Chapter 12.
- The extended use agreement is not in place at the end of the year and the taxpayer failed to correct the noncompliance with the IRC §42(h) (6) requirements within one year of the date it was determined the agreement was not in place. See [IRC §42\(h\) \(6\) \(J\)](#) and Chapter 5.
- The taxpayer disposes of the building and the taxpayer is subject to recapture. For dispositions before July 31, 2008, recapture could be avoided if it was reasonably expected that the building would continue to be operated in compliance with IRC §42 requirements and the taxpayer posted a disposition bond with, or pledged securities to, the IRS. See Rev. Rul. 90-60 and Rev. Proc. 99-11. For dispositions after July 30, 2008, no recapture is required if it is reasonably expected that the building will continue to be operated in compliance with IRC §42. Beginning July 31, 2008, taxpayers who had posted disposition bonds could elect to discontinue maintaining the bond (or pledged securities) under Rev. Proc. 2008-60.

## **Imputed Qualified Basis in the Event of Casualty Loss in Disaster Area**

In the event of a casualty loss in a presidentially declared major disaster area, Rev. Proc. 2007-54 provides that the building's qualified basis at the end of the taxable years of the casualty loss and restoration period is the qualified basis at the end of the taxable year that preceded the President's major disaster declaration. See Rev. Proc. 2007-54, Section 7.02.

## **Qualified Basis Subject to Recapture**

The allowable credit for the qualified basis at the end of the first year of the credit period is determined based on the premise that the taxpayer is obligated to provide low-income housing for five years after the end of the 10-year credit period. Effectively, a portion of the allowable credit each year is claimed in advance of providing the low-income housing. If there is a decrease in qualified basis at any time subsequent to the first year of the credit period, then the portion of credit allowed in advance of performance is subject to recapture. The recapture provisions under IRC §42(j) are discussed in Chapter 16.

The 2/3 credit associated with increases in qualified basis is based on providing low-income housing for that taxable year only. Therefore, the credit is not subject to the recapture provisions under IRC §42(j). See IRC §42(j) (4) (C)

## **Summary**

Qualified basis is computed as the product of the eligible basis and applicable fraction.

Qualified basis is determined each year of the 15-year compliance period, even if no credit is allowable.

Qualified basis may increase after the end of the first year of the credit period, but only if the number of qualified low-income units increases after the end of the first year of the credit period; i.e., the applicable fraction increases. Credit associated with the increase in qualified basis is known as the 2/3 credit and is allowable for each taxable year of the 15-year compliance period.

Increases in eligible basis after the end of the first year of the credit period do not increase qualified basis.

The maximum qualified basis is determined by the state agency at the time the credit allocation is made so that the amount of credit allocated does not exceed the amount necessary to ensure the building's financial feasibility and viability. Maximum qualified basis may be equal to or less than, but should not be more than, the actual qualified basis.

Qualified basis in excess of the maximum qualified basis is commonly referred to as "excess basis" and is associated with costs includable in eligible basis.

The cost of facilities used to provide supportive services can be included in eligible basis if the building qualifies as transitional housing under IRC §42(i) (3) (B) (iii). The qualified basis is increased by the lesser of the eligible basis of the building used to provide the supportive services or 20% of the qualified basis of the building determined without regard to the eligible basis of the building used to provide the services.

A building's qualified basis is deemed to be zero if:

- The entire building is noncompliant with IRC §42 requirements.
- The minimum set-aside requirement under IRC §42(g) (1) is not satisfied.
- An extended use agreement is not in place at the end of the taxable year and the taxpayer has failed to correct the noncompliance within the one-year correction period.
- The taxpayer disposes of the building and is subject to recapture; i.e., it is not reasonable to expect that the building will continue to be operated as a qualified low-income building for the remainder of the compliance period.

Only the qualified basis determined at the end of the first year of the credit period is subject to the IRC §42(j) recaptures provisions.

In the event of a casualty loss qualifying for relief under Rev. Proc. 2007-54, the imputed qualified basis for the year(s) of the casualty loss and the restoration period is the qualified basis at the end of the taxable year proceeding the year of the casualty event.

IRC §42 is often written using the term "qualified basis" rather than specifying the eligible basis or the applicable fraction. Caution is warranted when applying rules written in the "qualified basis" context.